

# FISCAL NOTE

**Bill #:** SB0338

**Title:** Flat income tax as percentage of federal income tax

**Primary Sponsor:** Tropila, J

**Status:** As Introduced

Sponsor signature	Date	Chuck Swysgood, Budget Director	Date
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## Fiscal Summary

### Expenditures:

General Fund

### FY 2004

#### Difference

\$3,317,110

### FY 2005

#### Difference

\$3,339,860

### Revenue:

General Fund

\$(85,962,000)

\$(172,681,000)

### Net Impact on General Fund Balance:

\$(89,279,110)

\$(176,020,860)

- |   |   |
|---|---|
| <input type="checkbox"/> Significant Local Gov. Impact    | <input checked="" type="checkbox"/> Technical Concerns            |
| <input type="checkbox"/> Included in the Executive Budget | <input checked="" type="checkbox"/> Significant Long-Term Impacts |
| <input type="checkbox"/> Dedicated Revenue Form Attached  | <input checked="" type="checkbox"/> Needs to be included in HB 2  |

## Fiscal Analysis

### ASSUMPTIONS:

1. This bill significantly changes the state's individual income tax structure by tying state tax liability to adjusted federal tax liability, net of any federal credits, including the earned income tax credit.
2. The bill is effective December 31, 2003; and applies to tax years beginning after December 31, 2003. There will be an impact on revenues in fiscal year 2004 as taxpayers will adjust quarterly estimated tax payments due in April and June of 2004, and the Department of Revenue adjusts withholding tables effective January 1, 2004 for the changes provided for in this bill.
3. Under this proposal, taxpayers with certain types of income will have to calculate "adjusted federal taxable income" and apply federal tax rates to that base to arrive at "adjusted federal tax liability". The taxpayer's state tax liability would then be calculated by applying a tax rate of 26% to adjusted federal tax liability net of any federal income tax credits that the taxpayer is allowed. The following schedule shows how state tax liability would be calculated under this proposal, and lists the specific adjustments provided for in the bill:

### Federal Taxable Income

Plus:	Interest on Non-Montana local government obligations
Less:	Railroad retirement income
	Interest on US government bonds
	Veteran's bonus payments
	Active duty military pay

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	Unemployment compensation included in FAGI
	Tip income
	Contributions to medical savings accounts
	Contributions to family education savings accounts
	<u>Contributions to first-time homebuyer savings accounts</u>
<b>Equals:</b>	<b>Adjusted Federal Taxable Income</b>
Times:	<u>Federal tax rates (including special treatment of capital gains income)</u>
<b>Equals:</b>	<b>Adjusted federal tax liability</b>
Less:	Federal credits, including the nonrefundable portion of the earned income tax credit
Times:	<u>26%</u>
<b>Equals:</b>	<b>State tax liability before state credits</b>
Less:	<u>State tax credits</u>
<b>Equals:</b>	<b>Net state tax liability</b>

4. The following table shows the impact of this proposal on tax year liabilities of full-year resident individual income taxpayers:

SB338 - Impact on CY Tax Liability		
Tax Component	Tax Year 2004	Tax Year 2005
Federal Tax Liability Before Credits - CL	1,626,286,515	1,667,698,851
<b>Federal Tax Liability Before Credits - PL</b>	<b>1,609,253,194</b>	<b>1,649,333,150</b>
Federal Credits, Other Than EITC:	(95,183,000)	(95,183,000)
Earned Income Tax Credit:	(100,341,000)	(100,341,000)
Excess EITC:	84,068,000	84,068,000
PL Tax Base:	1,497,797,194	1,537,877,150
Tax Rate:	26%	26%
PL Tax Liability:	389,427,270	399,848,059
CL Tax Liability:	536,557,036	557,888,867
<b>Change in Tax Liability:</b>	<b>(147,129,766)</b>	<b>(158,040,808)</b>

5. Under this proposal, the tax liability of full-year resident taxpayers is reduced \$147.130 million in tax year 2004 and \$158.041 million in tax year 2005.
6. The above reductions in *tax year tax liability* are estimated to reduce *fiscal year collections* by \$85,962,000 million in fiscal year 2004; and by \$172,681,000 million in fiscal year 2005.
7. The Department of Revenue would incur substantial administrative costs to implement this bill. The extent of the system changes required by this bill would warrant the creation of an entirely new application for the administration of the income tax. The project would require the equivalent of an additional internal 3.69 FTE in fiscal years 2004 and 2005, contracting for system development and maintenance with an outside vendor for the new system, and certain operating expenses and equipment.

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The increase in administrative expense totals \$3,317,110 in fiscal year 2004 and \$3,339,860 in fiscal 2005.

<u>FISCAL IMPACT:</u>	FY 2004 <u>Difference</u>	FY 2005 <u>Difference</u>
FTE	3.69	3.69
<u>Expenditures:</u>		
Personal Services	\$526,395	\$524,386
Operating Expenses	\$10,129	\$10,262
Equipment	\$21,419	\$0
Contracted Services – Outside Vendor	\$2,187,500	\$2,237,500
Contracted Services – ITSD, Mid-Tier Storage, etc.	<u>\$571,667</u>	<u>\$567,712</u>
TOTAL	\$3,317,110	\$3,339,860
<u>Funding of Expenditures:</u>		
General Fund (01)	\$3,317,110	\$3,339,860
<u>Revenues:</u>		
General Fund (01)	\$(85,962,000)	\$(172,681,000)
<u>Net Impact to Fund Balance (Revenue minus Funding of Expenditures):</u>		
General Fund (01)	\$(89,279,110)	\$(176,020,860)

### LONG-RANGE IMPACTS:

Under this bill, individual income tax revenue will be lower than under current law by an estimated \$188.163 million in fiscal year 2006. Impacts of this magnitude will continue in fiscal years after this.

### TECHNICAL NOTES:

1. Section 1 of the bill provides that a state income tax is imposed upon “the adjusted federal taxable income” of the taxpayer when the new state tax is actually a percentage of the taxpayer’s adjusted federal tax liability.
2. Section 1, subsection (2)(d) provides that 1) contributions to; 2) principal and income in, and 3) money withdrawn from medical savings, family education savings, and first-time homebuyer savings accounts may be deducted from federal taxable income when determining state tax liability. This provides for deducting the same contribution multiple times for these accounts.
3. Under this proposal, the taxpayer’s state tax liability is 26% of the taxpayer’s federal tax liability, less any federal credits. Section 1, subsection (3)(a) provides for proration of a nonresidents federal tax liability based on the ratio of Montana to total income, but the bill does not provide for proration of a nonresident’s federal credits prior to subtracting them from the prorated federal taxable income. This could act to exempt many nonresident taxpayers from having to pay any tax to the state.
4. Section 1, subsection (3)(b) provides that if a nonresident’s federal adjusted gross income is zero or less that the nonresident’s federal income tax liability for the purposes of this bill is the full amount of the nonresident’s federal tax liability which would be zero.
5. Section 2 provides the taxpayer’s state income tax is equal to 26% of adjusted federal tax liability, less federal credits. Federal credits include the very large, and refundable, earned income tax credit (EITC). The bill is not clear whether taxpayers, for state tax purposes, would be allowed to obtain a refundable

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state tax credit by multiplying the refundable portion of the federal credit by 26%, or if the excess portion of the federal EITC would not be considered for state tax purposes.

6. Section 3 provides for the taxation of nonresidents with respect to certain items of Montana income, but does not relate it to the retained definition of "Montana source income" in 15-30-101. The limited language might be read to exclude tax on Montana source income from pass-through entities. Section 3 should be clarified to determine the intended treatment of income derived from pass-through entities. The new definition of "Montana adjusted gross income" in amended 15-30-101 (sec. 13), which speaks only of income a nonresident "receives" and section 13's elimination of the definition of "received" in the same section, would appear to have the effect of avoiding tax on the pass-through entities' owners' distributive shares of income.
7. Section 5, subsection (1)(b) provides for "the amount of tax due under [section 2], less credits, if any, claimed against the tax". It is presumed that in this instance these credits refer to state-specific credits, but it would be clearer if the bill made this distinction explicitly.
8. Section 21, which amends the current law statutes pertaining to the charitable endowment credit, continues to provide that the taxpayer may not take a state credit for contributions to charitable endowments if the taxpayer has included the full amount of the contribution as a deduction. If the taxpayer takes the full deduction for federal purposes, the taxpayer will have to recompute federal itemized deductions, including any limitation on those deductions for high-income taxpayers, in addition to recomputing federal taxable income for any income adjustments required under the bill, before being able to take the state tax credit for this contribution.
9. In general, the sections of the bill amending the existing Montana credit provisions do not address the effect of federal deductions or credits for the same expenditures. Whether double credits for federal deductions and state credits for expenses already deducted in the federal return is intended should be clarified.
10. Section 29 amends the current Montana farm and risk management account laws to provide that contributions may be excluded from *federal adjusted gross income*. Because the reference is to federal adjusted gross income, but the starting point for the new state tax liability computations is federal taxable income, any amendments to current state law allowing a deduction from federal adjusted gross income will have no impact, and will not provide the taxpayer with any benefit from the deduction. There are other places in the bill where amendments are provided to allow a deduction from federal adjusted gross income (see, e.g., Section 36, subsection (1), and Sections 37 and 38). In all of these instances the reference to federal adjusted gross income should be changed to federal taxable income.
11. Section 30 amends a section of law pertaining to the calculation of the composite tax liability of participants in pass-through entities in a manner that makes the computation very unclear.
12. The cost estimates provided herein are based on the limited time and resource constraints inherent in the fiscal note process. Furthermore, these costs, while incorporating estimates for contingency and IV&V costs, were derived without the benefit of ITSD / CIO recommended project methodology. An analysis of the full range of alternatives would include an assessment of the feasibility of major overhaul of the existing system or a number of replacement options. We have not had the opportunity to speak with all software vendors who may be able to provide a proven, commercially-available integrated tax system containing multiple tax types and functions. An analysis of this scope could identify a more cost-effective alternative.